



OFFICE OF  
THE COMMISSIONER

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

September 20, 2001

Honorable John D. Dingell  
Ranking Member  
Committee on Energy and Commerce  
U.S. House of Representatives  
2322 Rayburn House Office Building  
Washington, D.C. 20515-6115

Dear Congressman Dingell:

On July 21, 2000, then-Chairman Arthur Levitt transmitted to you a Securities and Exchange Commission staff report regarding an enforcement action instituted and settled by the Commission against the New York Stock Exchange ("NYSE") on June 29, 1999. In its administrative order, the Commission found that the NYSE had failed, without reasonable justification or excuse, to enforce federal laws and NYSE rules against unlawful proprietary and discretionary trading by NYSE floor brokers. On February 26, 2001, you wrote to me requesting additional information regarding particular issues associated with the NYSE's undertakings and related matters.

Staff of the Commission's Office of Compliance Inspections and Examinations recently conducted a special purpose examination to assess the NYSE's compliance with those undertakings. I am pleased to now provide you with the enclosed Commission staff response to your inquiry. The staff response contains information not previously made public, which the Commission has authorized me to provide to you in order that we might respond to your questions. As the response explains, the NYSE's compliance with its undertakings, though meaningful at this point, remains an ongoing process.

Please have your office contact Casey Carter, Deputy Director, Office of Congressional and Intergovernmental Affairs, at 202-942-0010 should you have any questions.

Sincerely,

A handwritten signature in cursive script that reads "Laura S. Unger".

Laura S. Unger  
Commissioner

cc: The Honorable W.J. "Billy" Tauzin  
The Honorable Michael Oxley  
The Honorable John J. LaFalce  
Mr. Richard Grasso



## Commission Staff Response to Congressman Dingell

### Regarding New York Stock Exchange

On February 26, 2001, Congressman John D. Dingell wrote then-Acting Chairman Laura Unger to request particular information with respect to a settled enforcement action brought by the Commission against the New York Stock Exchange, Inc. ("NYSE") in June 1999. In that enforcement action, the Commission found that the NYSE, without reasonable justification or excuse, failed to enforce compliance with federal securities laws and NYSE rules regarding unlawful proprietary and discretionary trading by floor brokers. Specifically, in its June 29, 1999 Order Instituting Proceedings ("NYSE Order"), the Commission found that the NYSE failed for years to uncover and halt schemes in which floor brokers illegally shared in trading profits and engaged in other conduct violating Section 11(a) of the Securities Exchange Act ("Section 11(a)"), Rule 11a-1 thereunder ("Rule 11a-1"), and NYSE Rules 90, 95, and 111. In settling the action, the NYSE, without admitting or denying the findings, undertook to implement several remedial measures mandated by the Commission in the NYSE Order. In his February 26, 2001 letter, Congressman Dingell specifically requested information regarding the NYSE's compliance with those undertakings, a topic that was the subject of a previous report from the Commission's staff to Congressman Dingell in July 2000. Congressman Dingell also requested information concerning the Commission's follow-up actions related to the enforcement case against the NYSE.

The following responds to the specific inquiries set forth in Congressman Dingell's letter.

#### ***Inquiry No. 1 - OCIE's Recent Inspection:***

*"The NYSE has informed the SEC staff that it has made 'significant' progress in complying with the surveillance and regulation undertakings. However, the SEC's Office of Compliance Inspections and Examinations believes that a*

*complete assessment can only be accomplished after an on-site inspection of the NYSE scheduled for September 2000. Please describe the results of that examination."*

The Commission's Office of Compliance Inspections and Examinations ("OCIE")

recently completed an inspection of the NYSE's compliance with the undertakings and found that the NYSE has made significant progress in complying with the surveillance and regulation

- undertakings. OCIE found that the NYSE has enhanced and improved its surveillance, examination, investigatory, and disciplinary programs for independent floor brokers in general compliance with the NYSE Order. OCIE found that the NYSE implemented a formal, biennial examination program for independent floor brokers. The NYSE also created and implemented the Trading Floor Liaison Unit to establish an on-floor regulatory presence. Additionally, the NYSE implemented a mandatory education program – discussed in greater detail below – to address floor members' obligations and prohibitions under the federal securities laws and NYSE rules.

- OCIE did, however, find some deficiencies in the NYSE's compliance with the undertakings, including the requirements that the NYSE conduct "ongoing, continuous surveillance of all Floor Members" and "ensur[e] that members of its regulatory staff are present on the NYSE trading floor during trading hours to surveil for potential trading violations." OCIE has discussed these issues with representatives of the NYSE's Regulatory Group at an exit interview, and the NYSE has agreed to implement specific measures to correct these deficiencies.

***Inquiry No. 2 - NYSE's retention of Independent Consultant:***

*"The NYSE retained Betty Santangelo of the law firm Schulte Roth & Zabel to serve as the independent consultant and she had until October 7, 2000, to submit her report to the NYSE Board of Directors for action by them. Please summarize her findings and*

*recommendations, if any, and their implementation status.”*

On March 9, 2001, having requested and received extensions of the deadline to complete her work, Betty Santangelo submitted her Independent Consultant’s Report (“Consultant’s Report”) to the NYSE’s Board of Directors. As required by the NYSE Order, the Consultant’s Report reviewed the NYSE’s rules, practices, and procedures (including interpretations and unwritten rules) applicable to all categories of Floor Members. Two major themes emerge from

- the Report. First, the Independent Consultant perceived a lack of coordination between two divisions of the NYSE’s Regulation Group responsible for oversight of Floor Members: the Division of Member Firm Regulation (“MFR”) and the Division of Market Surveillance (“MSD”). For instance, the Independent Consultant found that MFR personnel were unaware of the existence of certain interpretive material disseminated by MSD to the floor of the exchange and that employees within MSD charged with responding to questions on the trading floor from members were not provided with advance copies of certain material distributed by MFR to the floor members. Second, the Independent Consultant found that many areas of the Regulation Group lack a formal procedural structure with respect to certain critical aspects of Floor Member regulation. For instance, the Independent Consultant found that there was no formalized requirement or procedure for MFR and MSD to share information regarding informal disciplinary actions taken by either division, such as cautionary letters and summary fines. In connection with these themes, the Consultant’s Report made several recommendations.<sup>1</sup> First, it recommended that the NYSE standardize across divisions the internal procedures for informal

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<sup>1</sup> The Consultant’s Report also identified certain specific areas of concern that warrant further consideration, including MFR’s and MSD’s ability to review, surveil, examine and analyze trading errors, the range of issues that relate to Independent Floor Members who are also employed as part-time registered representatives, and MFR’s and MSD’s approval and monitoring of open phone lines on the trading floor.

actions like cautionary letters and summary fines. Second, the Consultant's Report recommended that the NYSE provide for the sharing of information relating to actions taken against Floor Members by MFR and MSD.

- To improve the procedural structure of Floor Member regulation, the Consultant's Report also recommended that the NYSE create a centralized rulemaking department that would include all of the areas of rulemaking with a direct reporting line to the Group Executive Vice President.<sup>2</sup> The Consultant's Report further recommended making organizational changes to the NYSE Rule Book in order to strengthen its utility and effectiveness. It recommended that the NYSE more effectively control the dissemination of regulatory material issued by the NYSE to its members, and maintain key materials in a central file system, organized by NYSE rule, to facilitate retrieval.

- The Independent Consultant found that, other than MFR's biennial examinations, the Regulatory Group was not conducting "ongoing, continuous surveillance of all Floor Members" or "ensuring that members of its regulatory staff are present in the NYSE trading floor during trading hours to surveil for potential trading violations." The Independent Consultant found that the NYSE's Regulatory Group had not established an on-floor presence to detect and deter violations, as required by the NYSE Order.

At its April 5, 2001 meeting, NYSE's Board of Directors accepted the Report and delegated to the Quality of Markets Committee responsibility for overseeing the preparation of responses to the Report and acting on all its recommendations. On April 23, 2001, Edward Kwalwasser, Group Executive Vice President of Regulation, presented the Independent

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<sup>2</sup> The Independent Consultant also analyzed 141 NYSE rules and 15 SEC rules applicable to Floor Members, and made recommendations with respect to certain rules found to be problematic.

- Consultant with a memorandum detailing the NYSE's response. The NYSE concurred with, and stated its intention to implement all of, the Independent Consultant's principal recommendations with one exception: the NYSE proposed that it implement the recommendation to create a centralized rulemaking and interpretation function by appointing a specific committee to serve that function rather than by developing a separate department.

***Inquiry No. 3 - Education Program:***

*"The SEC and NYSE reports indicate that the NYSE instituted a mandatory education program for all floor members commencing in May 2000. Attendance at the sessions is monitored by an automated system which records members' badges. At the time of your reports, 120 days had not passed since attendance at continuing education sessions had become mandatory and so enforcement of the provision, by precluding members from entering the Floor had not yet been necessary. Please provide an update on attendance and enforcement."*

The NYSE represents that it has completed its first mandatory education program in compliance with Undertaking No. 7 of the NYSE Order. This first program consisted of two mandatory one-hour classes, offered before the opening and after the closing of the trading session. The program ran from May 3 through October 11, 2000, with additional make-up classes scheduled from October 18, 2000 through February 7, 2001. With input from senior Floor Members, MSD staff developed the program's content, which was approved by senior

- NYSE management and the Floor Directors. During this first program, the NYSE achieved almost universal attendance, with 1,360 members attending. Only one member failed to attend a scheduled class or the make-up sessions during the program's period. That member was

subsequently barred from the floor of the Exchange and has not since returned. The second mandatory education program began June 28, 2001 and is ongoing at this time.<sup>3</sup>

***Inquiry No. 4 - Electronic Order Audit Trail:***

*"The SEC and NYSE reports said that the rule proposals to implement the audit-trail undertakings were under review by the SEC staff. Have these rules been approved, and, if not, why not?"*

Undertakings Nos. 8 and 9 in the NYSE Order require the NYSE to develop and implement two phases of systems for the electronic capture of orders represented or executed on the NYSE floor. The first system ("Phase I Floor Audit Trail") will be used to generate an electronic record of details related to orders represented or executed on the NYSE floor. The second system ("Phase II Order Audit Trail") will provide an accurate, time-sequenced record of orders, quotations and transactions beginning with the receipt of an order by a member firm and continuing through that order's execution or cancellation. The Phase II Order Audit Trail also will provide for the synchronization of members' clocks with a time source designated by the NYSE.

The Commission published notice of the NYSE's proposed rule to implement the Phase I Floor Audit Trail, including two amendments, on August 12, 1999, and approved the rule on December 7, 2000. The new rule, codified as NYSE Rule 123(e), requires that the details of an order, including any changes in its terms and any cancellations, be recorded in an electronic system on the Floor prior to the order being represented or executed. Phase I records: (1) the order details; (2) the time the order details were entered into the system; and (3) the time of any modification or cancellation. Phase I became effective on September 10, 2001. Member and

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<sup>3</sup> The NYSE recently hired a Continuing Education Program Assistant to handle logistics of organizing the education program. Eventually, the NYSE hopes to provide classes by an interactive computer program rather than live presentations.



member organizations using proprietary or third-party vendor systems had to complete final system certification by July 28, 2001.

- The Phase II Floor Audit Trail will eventually be incorporated into a unified system with the Phase I Floor Audit Trail. The NYSE filed a rule proposal on December 22, 1999, for Phase II, essentially combining the Phase I system with the requirement to create a complete order audit trail from origination through execution and cancellation. The various data elements and information required by the proposed rule are generally comparable to the NASD's Order Audit Trail System ("OATS"). Under this system, NYSE members would create a unique identifier for each order that would enable the NYSE to track an order from receipt to settlement in an electronic format. Originally, the NYSE's proposed rule to implement Phase II required upstairs firms to process and report order information every day. However, in March 2001, the NYSE advised Commission staff that it intended to make significant substantive and technological changes to the system as proposed. The Commission had anticipated receiving an amendment noting these changes and publishing notice of the rule implementing Phase II by June 2001. However, the NYSE advised Commission staff that it would not be able to file such an amendment until after it held its August Board of Directors meeting. The Commission received the amendment on August 14, 2001, and is in the process of reviewing it.

***Inquiry No. 5 - Internal Audit:***

*"The NYSE reports that its Regulatory Quality Review department is functioning independently and in December 1999 submitted the results of seven recently-completed reviews and a plan of review for year 2000 to the Finance and Audit Committee of the NYSE's Board of Directors. Has the SEC reviewed these matters and is it satisfied with the quality and effectiveness of the enhanced internal audit function?"*

On July 28, 2001, the NYSE submitted a sworn affidavit stating that, pursuant to the undertakings of the NYSE Order, “the NYSE has maintained the Regulatory Quality Review Department (“RQR”) as a substantial, independent internal audit staff that has adequate resources to, and does, regularly review all aspects of the NYSE for which it had responsibility at the time the Order was entered, including, but not limited to, the regulatory function, the disciplinary process and the surveillance of trading on the NYSE.” The affidavit goes on to state that “the NYSE has increased the funding and staffing levels allocated to RQR, and RQR has significantly increased the number of reviews it performs annually, in comparison to prior years.” Finally, the affidavit states that “the NYSE has implemented or agreed to implement all recommendations made by RQR since the date of the Order, June 29, 1999.”

Although an examination of all of the RQR reviews was beyond the scope of her mandate, the Independent Consultant analyzed the findings of a number of RQR’s reviews. The Independent Consultant focused particularly on those RQR reviews that had detected problems with specific NYSE rules applicable to floor members, and interpretations of these rules, as well as instances in which the NYSE has applied unwritten rules. In this regard, the Independent

- Consultant has made recommendations to the NYSE regarding the RQR review process. Her recommendations include increasing coordination within RQR as well as continuing to increase the funding and staffing allocated to RQR for its review process.

***Inquiry No. 6 - Delayed Production of Documents by the NYSE  
and the NYSE’s Committee Reports on Intraday Trading:***

*“The Street.com and Wall Street Journal articles referenced in the opening paragraph raise at least two troubling questions which need to be answered. First, the handwritten notes, one of which said ‘Do not tell the SEC’ and another with the notation ‘nothing in writing’ which recently surfaced beg the questions: why weren’t these documents produced two years ago, and what did NYSE officials know about the unlawful activity and when did they know*

*it? I understand that the SEC and the U.S. Attorney's Office are looking into these issues. Second, the NYSE reportedly sent a copy of an internal committee report on the intraday trading in question to the SEC in 1993, which begs the question: who at the SEC reviewed that report and did they explicitly or implicitly sign off on it or did they raise red flags?"*

a. **NYSE's Document Production.** The Commission staff engaged in a variety of probing inquiries after receiving – in October and December 2000 – certain additional documents that were clearly responsive to document requests served on the NYSE during the Commission's investigation into the NYSE in late 1998 through June 1999. In early 2001, the staff conducted an aggressive investigation regarding the documents, interviewed several witnesses, and after careful consideration, concluded that (1) the failure to produce the documents was inadvertent and (2) the documents in any event are not "smoking guns" as portrayed by certain media sources, but rather are wholly consistent with the facts uncovered during the Commission's investigation and described in the NYSE Order. Moreover, the documents support the findings of the Commission in the NYSE Order that the NYSE's floor broker regulatory program was materially inadequate because, among other things, the NYSE failed to surveil for and investigate illegal profit-sharing arrangements by floor brokers. In short,

- the Commission's enforcement staff found no persuasive evidence that the NYSE knowingly withheld these documents, nor are the documents themselves evidence of knowing acquiescence of the NYSE staff in wrongdoing by floor brokers.

b. **1991 and 1993 Reports on Intraday Trading.** Although the NYSE was aware

- of intraday trading – a/k/a "flipping" – on the floor, it never communicated to the Commission, prior to the Commission's investigation, that it was failing to surveil for and halt the illegal profit-sharing arrangements that were the heart of the NYSE Order. The NYSE established two committees – one in 1991 and one in 1993 – to study whether to regulate intraday trading by

floor brokers as that practice, by itself, was not a violation of the securities laws or NYSE rules.

In November 1993, the NYSE communicated with the Commission's Division of Market

*Regulation about intraday trading and forwarded the reports of those 1991 and 1993 committees*

- to the Division. While the 1991 committee report mentioned profit-sharing issues, the NYSE never told the Commission that it was allowing profit-sharing. In fact, the one passage in the 1991 report that discusses profit-sharing explicitly states that, in the view of the NYSE committee, profit-sharing arrangements *would* violate Section 11(a) if the floor broker and its customers intended to act as partners. That 1991 report explained that profit-sharing by floor brokers was an issue for the NYSE's Regulatory Group. The 1991 and 1993 reports ultimately resulted in an amendment to NYSE Rule 95(c) to regulate intraday trading at the NYSE, which the Commission approved on July 13, 1994.

There is no record of any staff response to either of the two reports. However, it would be improper to conclude that the 1991 report somehow implied that profit-sharing arrangements were permissible, or that a failure of the staff to respond to the 1991 report somehow condoned the practice. To the contrary, the 1991 report demonstrated that the NYSE committee was aware that profit-sharing arrangements could violate Section 11(a) and, significantly, that the committee believed the NYSE should examine such arrangements as part of its regulatory program.